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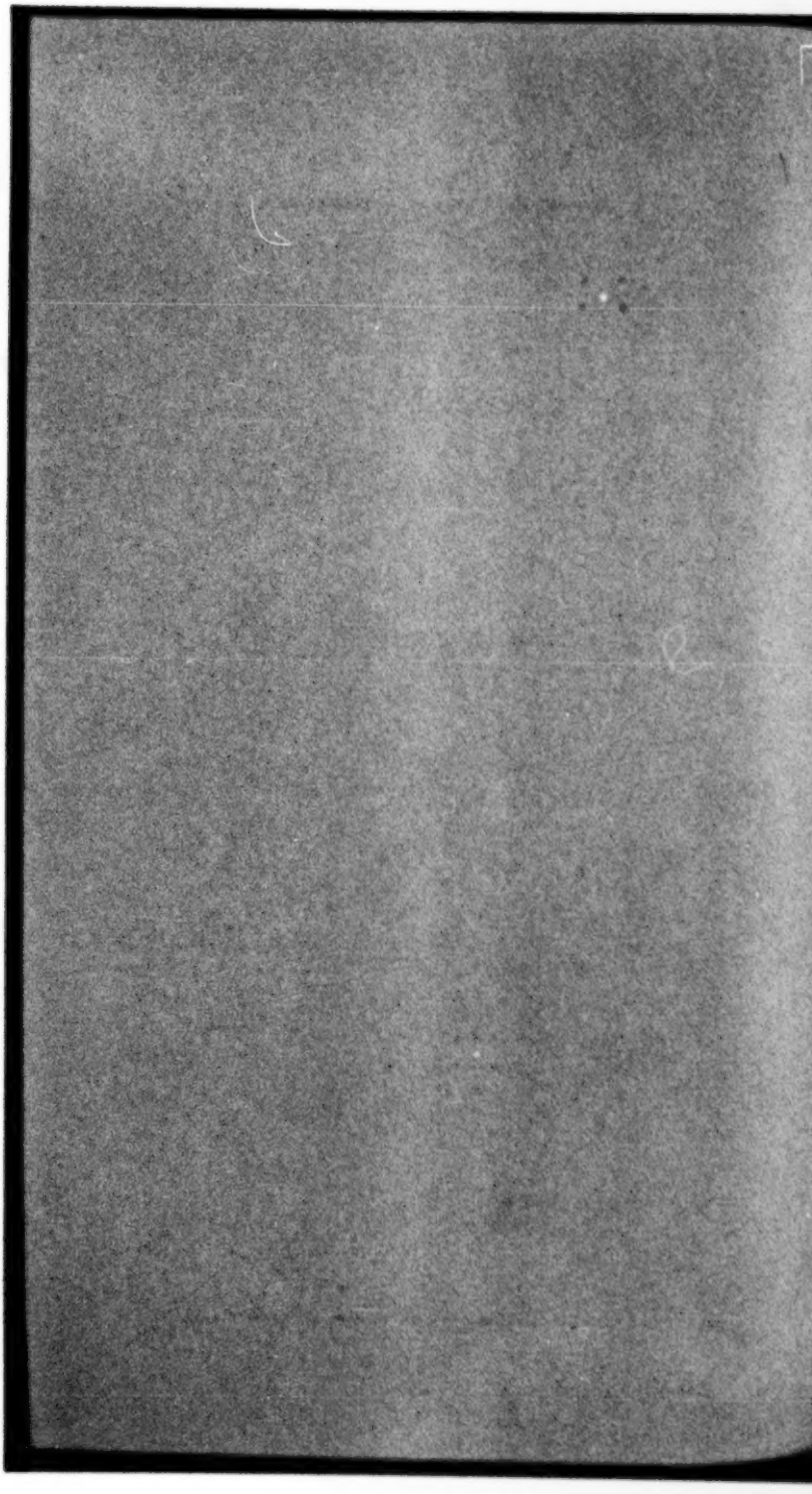

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Supreme Court of the United States

OCTOBER TERM—1926.

No. 661.

THE EQUITABLE TRUST COMPANY OF NEW YORK, as Trustee in Bankruptcy of Knauth, Nachod & Kuhne,
Petitioner,

against

FIRST NATIONAL BANK OF TRINIDAD, COLORADO,
Respondent.

APPEAL FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

MOTION FOR PERMISSION TO FILE A BRIEF AS AMICUS CURIAE IN THE ABOVE-ENTITLED CAUSE ON BEHALF OF FIDELITY TRUST COMPANY OF NEW YORK, HAVING A SIMILAR CLAIM AGAINST THE BANKRUPT ESTATE.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

COMES NOW Fidelity Trust Company of New York, by its counsel, requesting permission to file the following brief as amicus curiae in the above-entitled cause.

Statement.

This is a review on a writ of certiorari of a decision of the Circuit Court of Appeals, Second Circuit, reversing an order of the District Court for the Southern District of New York, and remanding the cause with instructions to grant the above-named respondent a priority in its claim against the estate of the bankrupts.

The bankrupts, Knauth, Nachod & Kuhne, were international bankers. As part of their business they offered what they called a "Drawing Service," pursuant to which banks throughout the United States acquired the "privilege" of using the world-wide facilities of the bankrupts for carrying on a foreign exchange business (fol. 419). The American banks issued as principals their own drafts (supplied in blank form by the bankrupts) on any of the banks named in the bankrupts' list of correspondents, paying funds to the bankrupts, who undertook, "as the agents of the drawers," to advise the drawees and provide funds for the payment of the drafts. Pursuant to this Drawing Service, First National Bank of Trinidad drew a draft on an Italian bank for 24,360 lire, and delivered to the bankrupts $1,191.20, to be used for the payment of said draft. The bankrupts duly notified the Italian bank of the drawing of the draft and requested it to charge same to their account, and the Italian bank thereupon charged the account of the bankrupts with the amount of the draft and credited the amount to a "Drafts Payable" account. Before the draft was presented for payment, a petition in bankruptcy was filed against Knauth, Nachod & Kuhne, and a receiver was appointed, who instructed the Italian bank not to pay the draft, and pursuant to his direction the Italian bank subsequently recredited all amounts standing in their Drafts Payable account which

had not been paid, and remitted the amount thereof to the receiver. The draft was thereafter presented to the Italian bank and dishonored, and was returned to the purchaser, who collected the amount thereof from the respondent and delivered the said draft to the respondent.

On the hearing before a Special Master it was stipulated that a large number of other banks had similar claims.

In behalf of the claimant it was contended, first, that the moneys remitted to the bankrupts were received by them as agents of the remitter for the purpose of applying the same to the payment of the draft, and, second, that there was an equitable assignment by the bankrupts of the moneys on deposit by them with the Italian bank for the payment of the draft. The Special Master held that the bankrupts did not receive the money as agents of the remitter or in a fiduciary capacity, and that there was not an equitable assignment. The District Court confirmed the report of the Special Master. The Circuit Court of Appeals reversed on the ground that the agreement to transfer the credit, followed by its actual transfer, provided a fund which the drawee was obliged to devote to the payment of the draft, and created an equitable assignment or an irrevocable declaration of trust by the bankrupts, and in view of that ruling found it unnecessary to consider the claimant's first point, whether the bankrupts originally received the claimant's check in a fiduciary capacity.

The Fidelity Trust Company of New York is not one of the banks included in the above-mentioned stipulation.

Pursuant to the Drawing Service conducted by the bankrupts, the Fidelity Trust Company of New York drew a draft on an English bank and remitted the required moneys to the bankrupts, who duly advised the English bank of the drawing of the draft and instructed it to honor the draft and charge their account. There is, how-

ever, this difference in the situation of Fidelity Trust Company of New York. The English banks, unlike the banks of most of the continental countries, did not, on receipt of such advice, charge the account of Knauth, Nachod & Kuhne and credit the amount to a Drafts Payable account. They merely sent a form letter acknowledging receipt of the advice. In all other respects the situation was the same. It is the contention of the Fidelity Trust Company of New York that the decision of the Circuit Court of Appeals should be affirmed, but on a broader ground that that assigned by that Court. It is our contention that there was a completed equitable assignment or irrevocable declaration of trust when Knauth, Nachod & Kuhne, having received the moneys from the remitter, notified the drawee bank of the drawing of the draft and instructed it to pay the draft out of their moneys on deposit, and that while the entries in the books of the drawee bank may fortify the conclusion reached in the case at bar, they were not essential to the completeness of the equitable assignment or declaration of trust, and that such assignment or declaration of trust depended upon the acts of the parties to the Drawing Service, and did not depend upon the book entries made abroad by the bank on which the draft was drawn.

BRIEF.

I.

The moneys were received by the bankrupts to be applied to a particular purpose and were received and held in a fiduciary capacity.

The respondent contends that moneys remitted to the bankrupts, in connection with the drawing of a draft under

the terms and provisions of the bankrupts' Drawing Service, were received by the bankrupts as agents of the remitter for the purpose of applying the same to the payment of the draft, and were therefore held in trust, and that when the fund abroad was returned to the receiver, he held it upon the same trust that the bankrupts held the original remittance. We align ourselves with the argument of the respondent on this point. In their Drawing Service the bankrupts expressly held themselves out to their customers as acting in the capacity of "agents" for the purpose of advising the issue of the drafts and providing the drawee bank with funds to cover their payment. It is entirely unnecessary to hold that the technical relation of principal and agent existed. As held in the leading case of *Farley* v. *Turner*, 26 L. J. Ch. 710, and as pointed out by Mr. Justice Stone in his article in 21 Columbia Law Review 510, it is enough that the moneys were paid to the bankrupts to be used to meet the draft drawn in accordance with the terms of the Drawing Service, and that the bankrupts before the filing of the petition in bankruptcy had appropriated the moneys to their undertaking for account of the drawer by notifying the drawee of the drawing of the draft and requesting the drawee to honor it and charge their account.

We submit that this is not an ordinary case of the purchase of foreign exchange or an ordinary case where money is paid to a foreign exchange house in return for its agreement to provide funds in a foreign country. It has long been considered that it is a *fraud* to draw a check when there are no funds of the drawer in the hands of the drawee (*Bickerdike* v. *Bollman*, 1 Term. Rep. 405; *Clegg* v. *Cotton*, 3 Bos. & P. 239; *Merchant's Bank* v. *State Bank*, 10 Wall. 604; 2 *Daniel, Neg. Instr.*, Sec. 1596), although the rule is qualified to this extent—that even if the drawer has no money in the hands of the drawee, still if a check

be drawn under such circumstances as to induce the drawer to entertain a reasonable expectation that it will be paid, he has not committed a fraud and will be entitled to due presentment and notice of dishonor (8 *Corpus Juris* 686; *Mazukiewicz* v. *Hanover Nat. Bank*, 240 N. Y. 317; *French's Executrix* v. *Bank of Columbia*, 4 Cranch 141; *Dickins* v. *Beal*, 10 Pet. 572).

When the First National Bank of Trinidad, Colorado, or the Fidelity Trust Company of New York drew its check to the order of a customer upon a bank located in Europe, it represented that it had sufficient funds in that bank or had made appropriate arrangements for the payment thereof. Doubtless the average man who buys a check drawn by an American bank on a foreign bank assumes that the American bank has drawn against funds on deposit in the foreign bank. In drawing such a check and making the implied representation of funds available abroad, the American banks relied upon the Drawing Service offered them by Knauth, Nachod & Kuhne. Pursuant to the terms of that service they paid over the money which they had received from their customers (retaining only a trifling commission) to Knauth, Nachod & Kuhne, relying upon their promise to forward promptly their advice of the draft and provide the drawee with funds sufficient for the payment thereof, acting as agents of the drawer (fols. 422-423). We submit that this was not an ordinary contract relation, and that Knauth, Nachod & Kuhne assumed a fiduciary obligation to perform the duties expressly assumed by them as "agents of the drawer" and to exonerate the drawer from the implication of fraud.

II.

Under the circumstances of this case and as between these parties, there was a completed equitable assignment or irrevocable declaration of trust when the bankrupts notified the foreign bank of the drawing of the draft and instructed it to honor the same and charge their account.

We submit that the assignment or irrevocable declaration of trust was complete upon receipt by the foreign bank of the instructions given by the bankrupts, regardless of the entries made by the drawee on its books. This question was not presented to the Circuit Court of Appeals. In the case at bar, it appeared that the drawee, upon receipt of the advice, had actually charged the account of the bankrupts with the payment of the draft and credited the same to a Drafts Payable account. Indeed, it is the undisputed testimony in this case that this is a universal custom (fol. 348), although that is contrary to the fact. The Circuit Court of Appeals naturally referred to such entries by the drawee as an additional make-weight, and, of course, if the making of such entry was in accordance with the universal custom, it would be unimportant to consider the effect of such notification and instructions standing alone, without the support of the book entries. We submit that the fact that the drawee charged the account of the bankrupts on its books is not controlling, and that the equitable assignment or irrevocable declaration of trust found by the Circuit Court of Appeals would result, irrespective of the entries made by the drawee on its books.

The same Court refused to say that the actual transfer of the credit was a "vital distinction."

> *In re Gubelman* (Petition of Munteau), 13 Fed. (2nd) 730, 732.

In the Court below, Judge Hand first pointed out that even if the bankrupts remained liable after they had posted the advice to the drawee and the drawee had made the necessary entries on its books, they could so finally and completely devote the fund to the payment of the draft as to create themselves constructive trustees for the benefit of the holder, and then went on to say:

> "It is, however, proper to observe that if, as we think, the bankrupts did not remain liable after performance, their action in advising the drawee to transfer the credits was more plainly a final appropriation of the deposit than it would otherwise have been. On such a view, by those acts they had acquitted themselves of all their obligations, and certainly the contract intended that they should secure payment of the draft. If they secured it at all, it must have been when they did the last necessary act. As a make-weight, therefore, we give our reasons for saying that the limit of their obligation was to secure the entries upon the drawee's books."

It seems to have been the opinion of Judge Hand that when the bankrupts notified the drawee of the drawing of the draft and requested it to honor the same and charge their account, the bankrupts appropriated the funds abroad to the benefit of the holder and assumed a fiduciary relation. The Court of Appeals found it unnecessary to consider the claimant's first point, i. e., whether the bankrupts *originally* received the claimant's check in a fidu-

ciary capacity, but in discussing the question as to the possible effect of the Italian law, Judge Hand said:

> "The question is whether the bankrupts made themselves constructive trustees of their claim against the drawer; that question depends upon the law of the place where the supposed trustees acted. We cannot regard the making of the entries as the declaration of trust, even though without them the appropriation would have been incomplete. The bankrupts' fiduciary relation to the deposit was created by the contract, and by their appropriation of their funds to the benefit of the holder. These took place here. The drawee's compliance with their orders was at most only a condition * * *."

It seems strange that the relations between the drawer and Knauth, Nachod & Kuhne, dependent upon the contract between them, should be affected one way or the other by the action of the foreign bank, over which neither had any control. If the bankrupts held the moneys of the First National Bank of Trinidad upon an irrevocable trust, why should it be said that the Fidelity Trust Company of New York is in worse plight merely because the Italian banks were accustomed to make certain entries on their books on receipt of advice from the bankrupts, whereas the English banks were not accustomed so to do?

Knauth, Nachod & Kuhne were creditors of the foreign bank. They gave the debtor an order requesting it to pay the draft drawn by the American bank. An order by the creditor, given directly to the debtor, requesting him to pay a third person, is an assignment of the claim if the third person is notified of it by the creditor's procurement or acts upon it.

3 *Pomeroy, Equity Jurisprudence*, Sec. 1282.
5 *Corpus Juris*, 913.
1 *Williston on Contracts*, Sec. 426.
2 *Story, Equity Jurisprudence*, Secs. 1045, 1046.

The case at bar should be dealt with in the same way as though the drawer bank were the third person mentioned in the authorities. The American bank acted in reliance on the promise of Knauth, Nachod & Kuhne to order the foreign bank to pay the draft. When the order was given, the appropriation was absolute, and the American bank or the holder of its draft could avail of the trust in equity without reference to the assent or dissent of the mandatory. The Circuit Court of Appeals held that the bankrupts' fiduciary relation to the deposit was created by the contract and by their appropriation of their funds for the benefit of the holder of the draft. We contend that the appropriation was complete without the making of the entries by the foreign bank; but even if, without those entries, the appropriation would have been incomplete, the fact remains that by their acts the bankrupts assumed a fiduciary relation to the deposit in the hands of the foreign bank. Those funds were affected by a trust for the benefit of these drafts, and the funds so held in trust did not pass as part of the bankrupt estate and were wrongfully taken by the receiver in bankruptcy.

It has sometimes been said that the true test whether or not an absolute appropriation has been made out depends upon the point at whose risk the property is.

2 *Story, Equity Jurisprudence*, Sec. 1045.

Judge Hand, in the case at bar, expresses the opinion that the bankrupts did not remain liable after performance, that is, after the drawee set up the credit in favor of the holder. We submit that the obligation of the bankrupts was to provide funds for the payment of the draft, advise the drawee and instruct it to honor the draft. The acceptance of such instructions may be evidenced by book entries, or by letter of acknowledgment (as in the case of English banks), dependent upon the local banking cus-

tom. The bankrupts, in their drawing service, undertook to advise the drawee of the issue of drafts and provide the drawee with sufficient funds to cover their payment (fol. 423), but did not undertake to cause the drawee to make certain entries on its books. If the question is, upon whom would the loss fall in the event of the failure of the drawee bank, we submit that the drawer would have to look to the drawee from the time that the bankrupts performed their contract obligation by notification to the drawee, and that the bankrupts' performance was not dependent upon the making of book entries by the drawee bank.

The trustee in bankruptcy has sought to derive support from those cases which establish the rule that in the ordinary case where a check is drawn upon a bank account, followed by a letter of advice to the drawee bank instructing it to pay the check, there is no assignment. Such a case is *Eastman Kodak Co.* v. *National Park Bank*, 231 Fed. 320, affirmed 247 Fed. 1002. Cases of this type are, however, clearly distinguishable from the case at bar. In those cases the relationship is the ordinary one between depositor and banker. That is not true in the case at bar; nor in the case at bar is the claim based primarily upon the draft in question, but rather upon a contract relationship between the claimant and the bankrupts pursuant to which the instrument was drawn. Furthermore, in those cases, it was attempted to establish an assignment for the purpose of imposing liability upon the drawee bank. Whether or not the holder of the draft here in question had a cause of action against the foreign drawee bank need not concern this Court. The claim in suit is not against the drawee bank, but against Knauth, Nachod & Kuhne, a party whose name does not even appear on the instrument. The very cases laying down the rule that there is no assignment in the usual case of the drawing of a check,

followed by a letter advice, recognize that the rule is limited to cases of negotiable instruments where there are no distinguishing features.

> *Eastman Kodak Co.* v. *National Park Bank* (*supra*), at page 323.

This Court has held that where it was the understanding of the parties that a particular fund should be charged, equity will enforce such an intention as against parties charged with notice.

In *Fourth Street National Bank* v. *Yardley*, 165 U. S. 634, this Court said:

> "*As between a check holder and the bank upon which such check is drawn*, it is settled that, unless the check be accepted by the bank, an action cannot be maintained by the holder against the bank.
>
> It is also settled that *a check, drawn in the ordinary form does not, as between the maker and payee*, constitute an equitable assignment *pro tanto* of an indebtedness owing by the bank upon which the check has been drawn, and that the mere giving and receipt of the check do not entitle the holder to priority over general creditors in a fund received from such bank by an assignee under a general assignment made by the debtor for the benefit of his creditors.
>
> That the owner of a chose in action or of property in the custody of another may assign a part of such rights, and that an assignment of this nature, if made, will be enforced in equity, is also settled doctrine of this court. * * *
>
> Whilst an equitable assignment or lien will not arise against a deposit account *solely* by reason of a check drawn against the same, *yet the authorities establish that if, in the transaction connected with the delivery of the check it was the understanding and agreement of the parties that an advance about to be made should be a charge on and be satisfied*

> *out of a specified fund a court of equity will lend its aid to carry such agreement into effect* as against the drawer of the check, mere volunteers, and parties charged with notice." (Italics ours.)

This Court, in the same opinion, quoted with approval from *Coates* v. *First National Bank*, 91 N. Y. 26, where it was said:

> "* * * when in addition to the check there was an oral agreement between the drawer and payee, by which the former, for a valuable consideration, agreed to assign so much of the indebtedness of the bank to him as was represented by the check, and the check was given to enable the payee to collect and recover the portion of the debt assigned, the agreement operated as an assignment, and was sufficient to vest in the payee a title to that portion of the debt."

The principle that checks are not assignments is strictly limited by the facts of the particular case. This is made clear by an examination of the authorities collated by Professor Ralph W. Aigler in an article on "Rights of Holder of Bill of Exchange Against the Drawee," 38 Harvard Law Review 857.

Not only is the principle of these cases inapplicable to the case at bar because of the distinguishing characteristics already referred to, but the very form of the draft in suit takes this case out of the application of a principle which, at best, is limited to negotiable instruments. The form of the draft in question serves to substantiate the contention that as between the claimant and the bankrupts there was an assignment.

Each of these instruments reads as follows:

> "Pay from balance against this check * * *."

On its face, the draft was payable only from a certain unspecified "balance." An order which specifically requests payment out of a particular fund to which the drawer is entitled is construed as an assignment. An ordinary check is not an assignment because it is an order to the drawee to pay the sum ordered irrespective of the condition of the drawer's account. The essential question is whether a fund is referred to as merely a possible source of reimbursement for the drawee or whether the order is to be paid only from the fund (Uniform Negotiable Instruments Law, Secs. 1, 3; 1 *Williston on Contracts*, Sec. 425; 8 *Corpus Juris* 123; cases cited in Note, 35 L. R. A. 647).

The leading case in New York is *Munger* v. *Shannon*, 61 N. Y. 251. In that case, DWIGHT, C., writing for the Court, said:

> "The true test would seem to be whether the drawee is confined to the particular fund, or whether, though a specified fund is mentioned, he would have the power to charge the bill up to the general account of the drawer, if the designated fund should turn out to be insufficient. In the final analysis of each case, it must appear that the alleged bill of exchange is drawn on the general credit of the drawer."

In all cases in which a particular fund is designated in a draft and the language is ambiguous, the turning point is whether it was the intention of the parties that the payment should be made only out of the designated fund or whether the direction to the drawee to pay was intended to be absolute and the fund was mentioned only as a source of reimbursement or as a direction as to bookkeeping.

Brill v. *Tuttle*, 81 N. Y. 454, 457.

The same test is applied in the Federal Courts (*The Bank of the United States* v. *The United States*, 2 How. 711).

An order requesting the drawee to pay a sum of money "out of any moneys in his hands belonging to me" was held to be payable out of a particular fund and not to be a negotiable bill of exchange.

Averetts' Adm'r v. *Booker*, 15 Gratt. 163.

Counsel for the trustee has stated in a brief submitted to the Circuit Court of Appeals that the draft used was "very carefully drawn" to comply with the German Check Law (25 Commercial Laws of the World, 481), which requires that a check shall contain a direction addressed by the drawer to the drawee to pay a certain sum "*out of his property.*" Of course, the provisions of the German Check Law are entirely immaterial in the case at bar; the draft having been drawn in Colorado, payable in Italy. On its face it permits payment only from "balance against this check." Since the intention and understanding of the parties is material in establishing the nature of the instrument (*White's Bank* v. *Myles*, 73 N. Y. 335; *Brill* v. *Tuttle*, 81 N. Y., at p. 462), it does not follow that the instrument must be given the same effect in every situation and as against every party. The question before this Court has to do solely with the rights of the drawers as against the bankrupts. There is no need to consider the effect which should be given to these instruments in favor of or as against parties not involved in the case at bar.

The drawer had no balance whatever. The instrument was drawn on a form prepared by the bankrupts and furnished as part of their drawing service. While the American bank drew the checks, they were on these blank forms and were actually drawn on the funds of the bankrupts, and, as between the drawer, the drawee and the bankrupts,

were payable solely from the bankrupts' balance on deposit. It is not to be assumed that the drawee bank was authorized to pay on the personal credit of the *drawer*, because the drawer was entirely unknown to the drawee. There is nothing to show that the drawee could pay on the personal credit of the *bankrupts*, because the check was payable "from balance."

As a matter of fact, the checks supplied by the bankrupts under their drawing service were of a uniform color and appearance, and would be recognized by any of the bankrupts' correspondents as Knauth, Nachod & Kuhne checks. Under the circumstances, the language, "Pay from balance against this check," as between the drawer, the drawee and Knauth, Nachod & Kuhne, could have but one meaning, namely, "Pay from Knauth, Nachod & Kuhne's balance against this check." As between these parties, the instrument was, therefore, payable out of a particular fund.

Viewing the entire transaction as a whole, we submit that each draft, drawn as it was by authority of the bankrupts, should, as against the bankrupts' trustee, be construed as an assignment by the bankrupts of a sum of money on deposit with the foreign bank.

The equitable assignment resulting from the acts of the bankrupts was not revocable by them or by their receiver or trustee in bankruptcy.

> "Considering the transaction as an equitable assignment, it was irrevocable in equity as soon as it was delivered to the holders, and at law as soon as it was assented to by the defendant, so far as to require him to appropriate so much of the profits as were equal to the amount of the note, to its payment. (*Mcnomy* v. *Ferrers*, 3 J. R. 71-83; *Peyton* v. *Hallett*, 1 Caines 363; *Canfield* v. *Mooper*, 12 J. R. 346; 2 Story Eq. Jur., sec. 1044.) The principle of these cases is that in equity the fund is held in trust

for the creditor, and that he has an equitable lien upon it for the amount of his debt. * * * Even in a court of law though an order of this kind might be revocable until assented to, yet, after assent by the parties, the creditor's rights would become so fixed that the drawer could no longer revoke his direction (*Williams* v. *Everett*, 14 East. 581)."

Munger v. *Shannon*, 61 N. Y. 251, at p. 258.

CONCLUSION.

The moneys withdrawn by the trustee in bankruptcy from the foreign bank did not pass as part of the bankrupt estate because the money was originally received by the bankrupts in a fiduciary capacity, because there was a completed equitable assignment or irrevocable declaration of trust of the funds on deposit and because as between the parties before the Court the draft itself had the effect of an assignment. In arriving at these conclusions, the fact that a bookkeeping entry was or was not made by the drawee bank is not controlling.

The decree of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

HAROLD NATHAN,
Counsel for Fidelity Trust Company of New York.